93-1416

Supreme Court, U.S.
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No. 93----

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

NCR CORPORATION,

Petitioner,

v.

SOUTH CAROLINA DEPARTMENT
OF REVENUE AND TAXATION,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

1. Is the Foreign Commerce Clause violated when a State utilizes the standard three-factor formula to tax an apportioned share of the unitary income of a taxpayer when the unitary income includes royalty and interest income derived by the unitary activities of the taxpayer?

2. Where a state taxes the unitary income of a recipient of royalty and interest payments and where the State uses the standard three-factor formula utilized for unitary taxation, is the State required by the Due Process or Commerce Clauses to include in the recipient's factors the payroll, property and sales of the party that paid the royalty and interest?

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SOUTH CAROLINA DEPARTMENT
OF REVENUE AND TAXATION,

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On Petition For A Writ Of Certiorari To The Supreme Court Of South Carolina

RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION

Respondent, South Carolina Department of Revenue and Taxation (DOR), respectfully requests that Petitioner's request for a Writ of Certiorari to the Supreme Court of South Carolina be denied.

OPINIONS BELOW

Several decisions have lead to NCR's Petition. The first decision was made by the South Carolina Tax Commission as an administrative body on January 22, 1988. That decision is unreported and is found at Pet. App. F at 68a-72a. NCR disagreed with that decision and brought an action in the Trial Court of South Carolina which resulted in a decision of the Court of Common Pleas of Richland County on February 22, 1989. That decision is unreported and is found at Pet. App. E at 42a-67a. NCR disagreed with the Trial Court's decision and appealed to the South Carolina Supreme Court. On February 4, 1991, the South Carolina Supreme Court, in a reported decision found at 304 S.C. 1, 402 S.E. 2d 666 (1991), issued an opinion which required the remand of the matter to the Trial Court. This opinion of the South Carolina Supreme Court (NCR I) which required the remand is found at Pet. App. D at 26a-41a.

After a trial pursuant to the remand was concluded, the Trial Court, on November 26, 1991, issued its decision. That decision is unreported and is found at Pet. App. C at 10a-25a. NCR sought to have the remand decision amended, and such request resulted in the Trial Court issuing a Supplemental Order on Remand on July 11, 1992. The Supplemental Order is not reported and is found at Pet. App. B at 8a-9a. NCR disagreed with the Trial Court's conclusions and appealed to the South Carolina Supreme Court a second time. The South Carolina Supreme Court, on December 13, 1993, issued an opinion reported as *NCR Corp. v. South Carolina Tax Com'n*, 439 S.E.2d 254 (1993). That decision (NCR II) is found at Pet. App. A 1a-7a. NCR has disagreed with the conclusions of NCR II and has filed a Petition for Writ of Certiorari.

JURISDICTION

The jurisdiction in this Court is found at 28 U.S.C. Section 1257(a).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

U.S. CONST. art. I, Section 8, cl. 3, states in part the following:

> The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

The U.S. CONST. amend XIV, Section 1 states in part the following:

> No State shall . . . deprive any person of life, liberty, or property, without due process of law.

STATEMENT OF THE CASE

NCR is a multinational corporation in the business of developing, manufacturing, marketing, installing and servicing of business information processing systems. The business is extensive and is not isolated by location. In fact, all phases of NCR's business are conducted in South Carolina. Its operations in South Carolina include a West Columbia plant which develops, manufactures and markets NCR's line of Tower computers. Additionally, NCR's plant in Liberty, South Carolina, manufactures personal computers, and its operation includes several retail and service offices in South Carolina,

including offices in Columbia and Greenville. Products produced in South Carolina are distributed and sold throughout NCR's worldwide market.

NCR and its subsidiaries are a unitary operation, and in conducting its unitary business, NCR receives royalty income. The royalty income in dispute in this case is received from unitary foreign subsidiaries pursuant to patent licensing agreements, under which NCR authorizes the foreign subsidiary to manufacture and sell NCR's patented machines. Ownership in the foreign subsidiaries is normally 100% by NCR, with the exception of NCR's subsidiary in Japan, which has 70% ownership. The royalties which are in dispute here are received by NCR from its unitary foreign subsidiaries and are in the following amounts:

1981	1982	1983
$32,996,316	$39,242,371	$49,992,119

Interest income is also received as a part of its unitary business. NCR finances its foreign subsidiaries' accounts receivable and makes direct loans to them. In addition, NCR has funds deposited in foreign countries and derives interest income. The interest income in dispute is as follows:

1981	1982	1983
$18,304,080	$23,924,409	$16,562,396

NCR argues its rights under the Foreign Commerce Clause and Due Process Clauses are violated by South Carolina's statutory taxing scheme.

REASONS FOR DENYING THE REQUESTED WRIT

I. THE FOREIGN COMMERCE CLAUSE IS NOT VIOLATED WHEN A STATE TAXES AN APPORTIONED SHARE OF ROYALTY AND INTEREST INCOME WHERE SUCH INCOME IS PART OF THE TAXPAYER'S UNITARY INCOME AND WHERE THE STATE UTILIZES THE STANDARD THREE-FACTOR FORMULA IN ARRIVING AT THE STATE'S APPORTIONED SHARE OF THAT UNITARY INCOME.

NCR asserts South Carolina taxes NCR's royalty and interest income on an apportioned basis while the same income is taxed on an unapportioned basis by the foreign countries in which NCR does business. (Pet. p. 13) NCR concludes such taxation is inevitable multiple taxation in violation of the Foreign Commerce Clause. In NCR's view, double taxation is inevitable in the instant case since "we are not dealing here, as the Court was in *Container*, supra, with two different methods of 'divid[ing] the pie.' Rather, here (as in *Japan Line*) the entire pie has been subjected to tax by foreign jurisdictions, which leaves the states no room to tax even an apportioned slice." (Pet. p. 15)

NCR's argument fails for two reasons. First, in the instant matter, any potential multiple taxation is not inevitable. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 2933 (1983), is controlling here since just as in *Container*, supra, South Carolina and the foreign countries are merely dividing the same pie (the income of NCR) by different methods. One method that may potentially produce multiple taxation is not required to yield to another that may also create multiple taxation.

Second, NCR's multiple taxation argument is premised upon a showing that the State and the foreign jurisdiction are taxing the same income. The mere fact that the royalty and interest income taxed by the foreign countries is also in the pre-apportioned base used by South Carolina to calculate South Carolina's share of unitary income does not mean multiple taxation of the same income is present. Accordingly, there is no multiple taxation at all. (Pet. pp. 48a-50a)

A. No Inevitable Multiple Taxation Occurs.

Under a Foreign Commerce Clause analysis, a property tax is in danger of being stricken if it "creates a substantial risk of international multiple taxation, . . ." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451, 99 S.Ct. 1813 (1979). In applying this test to an income tax, the Court has modified the standard by stating that a "method of formula apportionment [that] 'inevitably' led to double taxation . . . might be reason enough to render it suspect." *Container*, supra, 463 U.S. at 195. In this case, NCR asserts South Carolina's formula is not only suspect but is also unconstitutional.

1. *Container*, Supra, Prevents A Conclusion Of Inevitable Multiple Taxation Here.

As to the test of whether inevitable multiple taxation results, the Court in *Container Corp. v. Franchise Tax Bd.*, supra, resolved this issue when an income tax is apportioned under the standard three-factor formula such as that used by South Carolina. NCR is in error when it relies upon *Japan Line*, supra, as authority for its position.

In *Container*, supra, the parent corporation owned foreign subsidiaries whose earnings were purportedly taxed by the foreign governments in which they were located. The taxpayer, in *Container*, supra, contended that the *Japan Line* doctrine of

preventing international multiple taxation was violated because the California combined report method attributed a portion of the subsidiary earnings to California where they would be taxed again.

The Container Court acknowledged the similarity to Japan Line and stated that multiple taxation had occurred "in the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part." 463 U.S. at 187, 77 L.Ed.2d at p. 567. This multiple taxation, as in *Japan Line*, "stems from a serious divergence in the taxing schemes adopted by California [or South Carolina] and the foreign taxing authorities." **Ibid.** "In addition, the taxing method adopted by those foreign taxing authorities is consistent with accepted international practice," namely, the arms-length separate accounting method, as opposed to unitary formula apportionment methods adopted by California and South Carolina. What is most significant is that even though *Container*, supra, found that multiple taxation did occur, the Court still found no violation of Foreign Commerce and distinguished *Japan Line* on three grounds.

First, *Container*, unlike *Japan Line* "involves a tax on income rather than a tax on property." 463 U.S. at 187-8, 77 L.Ed.2d at p. 568. The Container Court noted that the "reasons for allocation to a single situs that often apply in the case of property taxation carry little force in the case of income taxation." 463 U.S. at 188, 77 L.Ed 2d at p. 568.

Second, the Container Court stated that "the double taxation in this case, although real, is not the inevitable result of the

California taxing scheme." Ibid. The Container Court noted:

> In Japan Line, we relied strongly on the fact that one taxing jurisdiction claimed the right to tax a given value in full, and another taxing jurisdiction claimed the right to tax the same entity in part--a combination resulting necessarily in double taxation. Id., at 447, 452, 455, 60 L.Ed.2d 336, 99 S.Ct. 1813. Here, by contrast, we are faced with two distinct methods of allocating the income of a multinational enterprise. The "arms-length" approach divides the pie on the basis of formal accounting principles. The formula apportionment method divides the same pie on the basis of a mathematical generalization. Whether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case.

Ibid.

Likewise, South Carolina, in including unitary foreign interest and royalties in NCR's pre-apportioned net income base, has not thereby inevitably taxed such income so as to subject it to multiple taxation by South Carolina and the foreign governments. There is no distinction between operating income of a foreign subsidiary and interest or royalties paid by such subsidiary. *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980); *Container Corporation of America v. Franchise Tax Board,* supra. In fact, inclusion of income in the taxpayer's apportionable unitary net income base has been held by this Court as not being a tax directly on specific income in that base. Rather, the tax is on unitary income. *Shell Oil Company v. Iowa Department of Revenue,* 488 U.S. 19,109 S.Ct. 278,

102 L.Ed.2d 186 at p. 199 (1988); *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 98 S.Ct. 2340, 57 L.Ed.2d 197 (1978). Contrary to NCR's multiple taxation argument, there is no inherent multiple taxation of NCR's income by South Carolina and a foreign country. The use of a method that taxes NCR's income under a "source nation" method of taxation (see Pet. p. 49a) cannot prohibit South Carolina from taxing NCR's income under a unitary approach. Under *Container*, supra, no violation of Foreign Commerce results.

Third, the Container Court distinguished Japan Line with an observation equally applicable to NCR in that "the tax here falls, not on the foreign owners of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States." 463 U.S. at p. 188, 77 L.Ed.2d at p. 568. The Container Court stated that it had specifically left open in *Japan Line* the application of that case to domestically owned instrumentalities engaged in foreign commerce. 463 U.S. at 188-9, 77 L.Ed.2d at p. 568. The Container Court found that these three "distinctions" between *Japan Line* and *Container* "add up to a constitutionally significant difference." 463 U.S. at p. 189, 77 L.Ed.2d at p. 568. Thus, no Foreign Commerce Clause violation can be established by NCR.

Contrary to NCR's perception of *Japan Line*, the Container Court noted that an absolute rule prohibiting multiple taxation at the international level was not a proper reading of that case. Instead, the Container Court stated in 463 U.S. at p. 189, 77 L.Ed.2d at p. 569 that:

> . . . such an absolute rule is no more appropriate here than it was in Japan Line itself, where we relied on much more than the mere fact of double taxation to strike down the state tax at issue. Although double

> taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to the taxing State.

The Trial Court correctly analyzed the multiple tax issue when it relied upon the "context" of the double taxation and the "alternatives reasonably available" to South Carolina as set forth by *Container*, supra, to avoid the double tax. (Pet. pp. 51a-52a) First, South Carolina could eliminate the double tax by not taxing NCR at all. In fact, this is precisely what NCR seeks. The Container Court dismissed this argument summarily by finding that the "obvious unfairness" of such a rule" requires no elaboration." *Container*, supra, 463 U.S. at p. 190. Second, South Carolina could adopt the arms-length approach used by the foreign countries. Container dismissed this alternative since under an arms-length approach "the possibility of double taxation also exists." *Container*, supra, 463 U.S. at p. 191. In short, *Container*, supra, found the apportionment of unitary income such as NCR's royalty and interest was no more susceptible to double taxation than was the arms-length approach advocated by NCR.

> Thus, even if [South Carolina] were to adopt some version of the arms-length approach, it would not eliminate the risk of double taxation of corporations subject to its [income] tax and might, in some cases, end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.

463 U.S. at p. 191.

These conclusions of the Container Court are equally applicable to NCR's foreign interest and royalties, and *Japan Line*, which

forbade multiple property taxation on the international level, is not applicable in the instant case and provides no support to NCR. *Container* is dispositive.

2. States That Have Applied *Japan Line*, Supra, Have Given It The Narrow Construction Intended By *Container*, Supra, And Such Results Demonstrate There Is No Confusion As To The Application of *Container*, Supra.

Application of *Japan Line*, supra, in the state courts, in the context of an income tax has been to limit the scope of the decision in accordance with *Container*, supra. As the following cases show, no support among sister states can be found for NCR's reliance upon Japan Line to support its multiple taxation view.

The most notable case is litigation by NCR in Minnesota. In *NCR Corp. v. Com. of Revenue*, 438 N.W.2d 86 (1989), NCR received royalties and dividends from its subsidiaries and, as is the case here, NCR and its subsidiaries operated as a unitary business. NCR claimed that taxing its royalty and dividend income violated the Foreign Commerce Clause since it was subject to income withholding tax on its foreign royalties and dividends by the foreign countries in which its subsidiaries operated. The Court dismissed NCR's double taxation argument by relying upon the *Container* rationale. In a somewhat less direct case, Oklahoma also declined to apply *Japan Line* in a broad manner. There a corporate income taxpayer claimed a deduction for taxes paid to foreign countries. The Tax Commission disallowed the deduction. The Court declined to apply *Japan Line* and held that the taxation of instrumentalities of foreign commerce was of limited applicability to the taxation of income. *Matter of Income Tax Protest of Flint Resources*, 780 P.2d 665, 671 (1989).

Finally, even in a pure property tax context, California has given a limited impact to Japan Line. In *Star-Kist Foods, Inc. v. County of Los Angeles,* 719 P.2d 987 (1986), the issue was whether an exemption on business inventories only for taxpayers involved in exporting and importing was a violation of the Commerce Clause. In finding the statute unconstitutional, the Court recognized the ability of the State to tax foreign commerce and distinguished *Japan Line* by holding that *Japan Line,* supra, was limited to the narrow circumstances presented in that case. *Star-Kist Foods,* 719 P.2d at p. 994.

As *Container,* supra, and the state courts have held, *Japan Line,* supra, has very little application to the instant case before this Court. Accordingly, the South Carolina Supreme Court properly relied upon *Container,* supra, in finding South Carolina's tax system did not result in an enhanced risk of multiple taxation so as to offend the Foreign Commerce Clause.

3. The Facts Of This Action Demonstrate There Is No Inevitable Multiple Taxation.

NCR asserts there is "dead certainty" that South Carolina's taxing method will create international multiple taxation. (Pet. p. 16) Such a conclusion is simply not true under the standard three-factor formula used by South Carolina.

"Inevitable" means incapable of being avoided or prevented. *American Heritage Dictionary,* Houghton Mifflin Company, 1976 Edition. Thus, the statement of "inevitable multiple taxation" must hold true for all fact situations involving NCR's patent and loaning activities. In at least two instances, the formula will not only prevent double taxation but will in fact reduce NCR's taxes.

NCR conducts extensive development activities. Not all

expenditures result in a profitable product in that a patent may be obtained at great cost and result in very little value. Other expenditures may result in failure with no income resulting. In short, NCR may create more expenses than it creates income. Clearly, NCR benefits under the formula. The expenses are deductions and deductions reduce NCR's income. Since the formula does not include the subsidiaries' factors, the deductions are not reduced by having to apportion the deductions to the foreign countries. Rather, a greater percentage of the deductions is apportioned to South Carolina and, thus, NCR's South Carolina tax liability is reduced.

NCR could prevent the "overtaxation" by simply transferring ownership of the patents to the subsidiaries. Under this arrangement, when NCR uses the patents, NCR would pay royalties to the subsidiaries. NCR itself would produce substantial deductions from royalties paid. These royalties paid would reduce NCR's net income. The percentage apportioned to South Carolina, not being diminished by the foreign factors, would apportion more of the deductions to South Carolina, thereby reducing the net income taxable in South Carolina. Accordingly, the formula would reduce NCR's South Carolina tax liability. Thus, again, the formula does not always and inevitably over tax NCR.

B. South Carolina's Unitary Taxation Does Not Tax The Same Income As That Taxed By The Foreign Countries And, Thus, There Is No Multiple Taxation.

NCR's multiple taxation argument is premised upon a showing that the State and the foreign jurisdiction are taxing the same income. The alleged proof of the taxation by South Carolina of the interest and royalty income is that such income is in the pre-apportioned base used by South Carolina to

calculate South Carolina's share of unitary income. Further, there is the assertion by NCR that the income included in the pre-apportioned base is foreign income. The inclusion in the pre-apportionment base does not mean multiple taxation of the same income is present nor does it mean that the income so included is foreign income. (Pet. pp. 48a-50a)

1. South Carolina Taxes Unitary Income Without Consideration As To Source.

NCR's view is that where ". . . the entire pie has been subjected to tax by foreign jurisdictions, . . . the state [has] no room to tax even an apportioned slice." (Pet. p. 15) NCR apparently agrees that *Container*, supra, is properly decided and, thus, it is proper for both foreign and state jurisdictions to tax a portion of the whole pie. (Pet. pp. 14-15) Such a view is tantamount to holding that a state may not tax income that is "foreign" (i.e. taxed by a foreign jurisdiction) unless the state taxes the income on the combined unitary method approved by *Container*, supra. Such a view creates two erroneous results. First, it forces those states using the unitary taxing method to chose the same method, i.e. the combined unitary method employed by a state like California. Second, NCR's view requires identifying the source of income in order to determine the taxability of that income.

a. No Standard Form Of Unitary Taxation Has Been Imposed By This Court.

The Supreme Court has never required a standard formula for employing the unitary method of taxation. This Court has found that the unitary concept "is not, so to speak, unitary; there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container*, 463 U.S. at 167, 77

L.Ed.2d at p. 555. Three methods are generally used with approval.

A state could select a unitary formula method whereby the taxpayer's apportionable unitary income base is limited to the taxpayer's operating income, whether from domestic or foreign sources. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n.*, 266 U.S. 271, 45 S.Ct. 82, 69 L.Ed. 282 (1924); *Underwriter Typewriter Co. v. Chamberlain*, 254 U.S. 113, 41 S.Ct. 45, 65 L.Ed. 165 (1920). Or, a state could validly select a method, as has South Carolina, whereby the taxpayer's apportionable unitary income would include operating income and investment income, whether from domestic or foreign sources. *Mobil Oil Corp. v. Commissioner of Taxes*, supra; *M. Lowenstein Corp., et al. v. South Carolina Tax Commission*, 298 S.C. 93, 378 S.E. 2d 272 (1989). Also, a state could select the combined report method whereby the entire net incomes of several commonly owned unitary corporations, whether domestic or foreign, are included in the taxpayer's apportionable unitary net income base. *Container Corporation of America v. Franchise Tax Board*, supra. A state is free to select whatever unitary method of taxation it feels is appropriate and has never been forced to adopt the combined method examined in *Container*, supra. NCR's view forces just such a result.

b. NCR's View Requires Identifying The Source Of The Income.

Whatever method the State selects to calculate the unitary income base, classification of the income as unitary income eliminates any consideration of the foreign source of the income. *Mobil Oil Corp. v. Commissioner of Taxes*, supra. Amounts included in apportionable income have no situs and to seek to find a situs is to literally destroy the very concept

upon which unitary/formula apportionment is based. This Court has previously rejected attempts to identify unitary income as having a particular situs.

In *Shell Oil Co. v. Iowa Dept. of Revenue,* supra, the taxpayer argued that Congress had forbidden states from taxing income earned on the Outer Continental Shelf (OCS) under the Outer Continental Shelf Lands Act (OCSLA). Shell, which conducted a unitary business of producing, transporting and marketing oil and gas, excluded the income it alleged was earned from oil produced on the OCS. Iowa included as part of the pre-apportioned income, the income allegedly earned from the OCS. In agreeing that Iowa was correct in including the income, this Court pointed out the fallacy of *Shell's* argument:

> Shell's argument hinges on the mistaken premise that including OCS-derived income in the preapportionment tax base is tantamount to the direct taxation of OCS production. But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa. As our Commerce Clause analysis of apportionment formulas has made clear, the inclusion of income in the preapportioned tax base of a state apportionment formula does not amount to extraterritorial taxation.

Shell, supra, at p. 284.

In other words, when income is included in the taxpayer's unitary base, the State is not taxing a specific class of income from a specific location. Rather, all classes of income (whether

originally foreign or domestic or whether from rent, royalty, interest, etc.) become a single type of income: unitary income. It is the unitary income that a state may constitutionally tax without regard to the alleged source or location of the income. See *Mobil Oil Corp. v. Commissioners of Taxes,* supra.

Amerada Hess Corp. v. Dir., N.J. Dept. of Treasury, 490 U.S. 66, 109 S.Ct. 1617 (1989), reiterated the position that income and deductions that are part of unitary net income are not assignable to a specific location. *Amerada Hess Corp. v. Dir., N.J. Dept. of Treasury,* supra, involved the attempt by the taxpayer to claim a deduction for its windfall profits taxes paid to the federal government. New Jersey disallowed the deduction since no deduction under New Jersey law can be allowed for taxes that are "on or measured by profits or income." The taxpayer countered by arguing that disallowing the deduction violated interstate commerce. The basis for this assertion was that since no oil was produced in New Jersey there would be no windfall profits taxes generated in New Jersey. Thus, the taxpayer reasoned that New Jersey was disallowing deductions generated in oil producing states and, therefore, caused New Jersey to "tax more than its fair share of the unitary income." *Amerada Hess,* supra, at p. 1622. In dismissing the taxpayer's argument, the Court stated the following:

> Appellants, however, underestimate the fact that, for apportionment purposes, it is inappropriate to consider the windfall profit tax as an out-of-state expense. Rather, just as each appellant's oil-producing revenue--as part of a unitary business--is not confined to a single State, Exxon Corp., 447 U.S., at 226; Brief for Appellants 8, so too the costs of producing this revenue are unitary in nature. See Container Corp., 468 U.S., at 182 (the costs of a unitary business cannot be deemed confined to the

> locality in which they are incurred). Thus, when a State denies a deduction for a cost of a unitary business, the resulting net figure is still a unitary one, which a State may legitimately decide to apportion according to the standard three-factor apportionment formula.

Again, the Court found the unitary nature of the income or deduction removed any consideration of where the income or deduction may have originated.

In the instant case, NCR is seeking to reassert the position denied in *Shell,* supra, and *Amerada Hess,* supra, by attempting to place a class of income and related expenses (here interest income and royalty income) at a specified location (here foreign countries). NCR has admitted its royalty and interest income is part of its unitary income. Such being true, there is no "foreign source" to such income. Rather, the income is properly apportionable under the now well established three-factor apportionment formula used for apportioning unitary income. See *Container Corp. of America v. Franchise Tax Board,* supra.

Thus, South Carolina has not taxed foreign source income and, accordingly, cannot be said to have taxed the same income that another jurisdiction has taxed. Rather, South Carolina taxes South Carolina's income, with such amount determined by a pre-apportioned base which includes various types of income from assorted transactions. NCR's assertion, throughout its Petition, that South Carolina has created multiple taxation misstates South Carolina's taxing system.

2. There Is Universal Agreement That Unitary Income Is Not Affected By The Source Of The Income.

The view that a particular class of income is somehow not

taxable because of the "source" of that income has been rejected in the state courts as well. In *Tenneco v. Com. of Rev.*, 516 N.E.2d 1164, 1168 (1987), the taxpayer carried on business in Massachusetts, but its foreign subsidiaries did not. The subsidiaries paid dividends which the taxpayer sought to exclude from income. The Court held that the mere labelling of the source of dividend income as foreign does not preclude a state from including that income in the pre-apportionment tax base. In *Comptroller v. Armco, Inc.*, 521 A.2d 785, 793 (1987), dividend and interest income was received by a parent from its subsidiary and the parent did not include them as income. In including the dividends and interest as part of the income base, the Court found that the character of the income prior to becoming part of unitary income had no relevancy to its taxability. Similarly, in *Hewlett-Packard Co. v. Dept. of Rev.*, 749 P.2d 400, 402 (1988), the issue was whether it was proper to include the income of foreign subsidiaries of a unitary business in a combined report when defining the limits of the unitary group and calculating the corporation's net income base. The Court found that the labelling of income as "foreign source" had no effect on its taxability.

II. WHERE A STATE TAXES THE UNITARY INCOME OF A RECIPIENT OF ROYALTY AND INTEREST PAYMENTS AND WHERE THE STATE USES THE STANDARD THREE-FACTOR FORMULA UTILIZED FOR UNITARY TAXATION, THE STATE IS NOT REQUIRED BY THE DUE PROCESS OR COMMERCE CLAUSES TO INCLUDE IN THE RECIPIENT'S FACTORS THE PAYROLL, PROPERTY AND SALES OF THE PARTY THAT PAID THE ROYALTY AND INTEREST.

NCR attacks South Carolina's formula on the ground that the formula is not properly reviewed under the gross disparity

test since South Carolina's formula is an "analytically indefensible apportionment regime...."(Pet. p. 23) In NCR's view, only "theoretically sound formulas" may employ the gross disparity test. (Pet. p. 23) According to NCR, South Carolina's formula is indefensible since it includes the royalty and interest income in the pre-apportionment base, but does not include the payroll, property and sales of the party that paid the royalty and interest. (Pet. pp. 17-18) NCR is incorrect in its view since it begs the question. The test has never been whether the formula is "theoretically sound" or "analytically indefensible." Rather, such labels only assume the answer in the framing of the label. The only acceptable test is whether "the factor or factors used in the apportionment formula . . . actually reflect a reasonable sense of how income is generated." *Container,* supra., 463 U.S. at 169.

A. Due Process And Interstate Commerce Are Not Violated Since South Carolina's Apportionment Formula Is Within the Requirements of Container, Supra.

Compliance with Due Process and Interstate Commerce is found by applying the following test set out by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board,* supra.

> . . . an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. See Exxon Corp., supra, 447 U.S. at 219, 227-228, 100 S.Ct. at 2118, 2122-2123; Moorman Mfg. Co., 437 U.S. at 272-273, 98 S.Ct. at 2343-2344; Hans Rees' Sons, Inc., 283 U.S. at 134, 51 S.Ct. at 389. The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency--that is, the formula must be

> such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency--the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not "invalidat[e] an apportionment formula whenever it **may** result in taxation of some income that did not have its source in the taxing State . . . "Moorman Mfg. Co., supra, 437 U.S. at 272, 98 S.Ct. at 2344 (emphasis added). See Underwood Typewriter Co., 254 U.S. at 120-121, 41 S.Ct. at 46-47. Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,'" [Hans Rees' Sons, Inc.] 283 U.S. at 135, 51 S.Ct. at 389, or has "led to a grossly distorted result," [Norfolk & Western R. Co. v. State Tax Comm'n., 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201 (1968)]. Moorman Mfg. Co., supra, 437 U.S. at 274, 98 S.Ct. at 2345.

NCR essentially challenges South Carolina's formula under the external consistency test.

B. External Consistency Is Satisfied Here Since The South Carolina Three-Factor Formula Reasonably Reflects South Carolina's Share Of The Unitary Income.

1. Inexactness Is Constitutionally Permitted.

The test of fairness under the Due Process and Commerce

Clauses requires satisfying an external consistency test which seeks to show that the apportionment factors "reflect a **reasonable** sense of how income is generated." (Emphasis added) *Container Corp.*, 463 U.S. at p. 169. In this formulation of the test, the Court underscores the view that the in-state factors in the formula are only to be reasonable. Exactness is not a requirement. In fact, to develop the view that rough approximations are valid, the Container Court identified the outer limits of what is reasonable by expressing the following at 103 S.Ct. at p. 2942:

> . . . we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is, in fact, 'out of all appropriate proportions to the business transacted . . . in that State,'" [Hans Rees' Sons, Inc.] 283 U.S. at 135, 51 S.Ct. at 389, or has "led to a grossly distorted result," [Norfolk & Western R. Co. v. State Tax Comm'n., 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201 (1968)]. Moorman Mfg. Co., supra, 437 U.S. at 274, 98 S.Ct. at 2345.

This Court has all but given blanket approval to the use of the three-factor formula in providing a fair apportionment of income. *Container Corp.*, supra, at 103 S.Ct. 2943; *Amerada Hess Corp. v. Director, New Jersey Dept. of Treasury*, supra.

It is in light of this extensive approval of the three-factor formula that NCR must conclusively demonstrate that South Carolina's apportionment is unfair in Due Process terms. NCR has a high burden of proof and must demonstrate there is no rational relationship between the income attributed to the State and the intrastate values of the enterprise, by showing the income apportioned to South Carolina is out of all

appropriate proportion to the business transacted in the State. *Container*, supra, 103 S.Ct. at 2948. That burden is not carried where the disparity is only 27.9%. (Pet. pp. 6a-7a)

2. NCR's Reliance Upon Justice Stevens' Dissent In *Mobil*, supra, Is Misplaced.

NCR relies upon Justice Stevens' dissent in *Mobil*, supra, 100 S.Ct. 1223 (1980). Its position is that the South Carolina apportionment factors do not reflect a reasonable sense of how income is generated unless the payroll, property and sales of NCR's subsidiaries are included with NCR's payroll, property and sales. This position is incorrect.

First, South Carolina is not taxing the income of the subsidiaries. Rather, the only income being taxed is the income of NCR itself. If the total income of the subsidiaries were taxed, it would be proper to include the subsidiaries' factors. Correspondingly, it is equally proper to not include the factors where none of the subsidiaries' income is taxed.

Second, *Mobil* concerned dividends rather than the royalty and interest income involved here. In the case of a dividend, the payment represents an actual part of the earnings of the subsidiary and it may be more appropriate in such a case to consider the factors of the subsidiary as a part of the apportionment formula; however, where the income paid out, such as royalty and interest, is a mere expense of the subsidiaries in performing their business in the foreign location, there are no "earnings" of the subsidiary that need to be accounted for in the factors of the recipient.

C. The State Court Decisions Cited By NCR Do Not Support NCR's Position.

1. *American Telephone and Telegraph Co. v. Wisconsin*

Dept. of Revenue, 422 N.W.2d 629 (1988), Is A Case Limited To Unique Facts And Was Decided Under The Gross Distortion Test.

AT&T is an interstate public utility which owns a substantial number of 100% subsidiaries from which it received dividends and interest. Wisconsin found these dividends and interest to be part of AT&T's unitary business and apportioned this income using the basic three-factor formula using only AT&T's property, payroll and sales.

AT&T argued that in order to comply with Due Process and the Commerce Clause, Wisconsin was required to include in the property factor of the formula, AT&T's book cost investment in and advances to its subsidiaries which it claimed generated the dividend and interest income.

In its Due Process analysis, the Court found that the Wisconsin formula was internally consistent since if all states used Wisconsin's formula, only 100% of the income of AT&T would be taxed. The Court concluded, however, that the formula was not externally consistent. The Court found that the amount of tax due in Wisconsin was out of proportion to the amount of business done in that state. AT&T's investment in subsidiaries was approximately $29.5 billion. Additionally, the subsidiaries paid about 75-80% of their net earnings annually to AT&T. In 1976, AT&T received $2,871,718,743 in dividend income from its subsidiaries. In fact, the bulk of AT&T's income was generated by subsidiaries which did no business in Wisconsin.

The Court found no problem with taxing this income since it was part of the integrated business of the taxpayer; however, the Court found that in this particular case, the apportionment formula does not bear a reasonable relation to the corporate

activities of the Bell System in Wisconsin. The taxes which are paid to Wisconsin are "grossly disproportionate to the benefits conferred."

It is important to note that the Lower Court found that AT&T's income in Wisconsin increased by 400% after the break-up. The Court did not strike down the apportionment formula; it simply found that the formula was not appropriate in this case. The test the Court applied was the "gross disparity test."

This gross disparity test was applied by the Trial Court in the instant case and it found 28% disparity. AT&T also applied the gross disparity test and it found a 400% disparity. The Court felt under the unique circumstances surrounding the break up of AT&T that such a disparity was too large. Obviously, no such unique circumstances are present in NCR and a 28% disparity is a far cry from 400%. AT&T does not support NCR's argument.

2. *Tambrands, Inc. v. State Tax Assesssor,* 595 A.2d 1039 (1991), Is Of No Support To NCR Since In The Instant Matter, There Is No Violation Of Internal Consistency.

Tambrands was a Delaware Corporation with its headquarters and commercial domicile in New York. It operated in a number of states, as well as having foreign affiliates in Canada, France and the United Kingdom. In 1984, *Tambrands* received $7,493,965 in dividends from its foreign affiliates.

Maine used the three-factor formula in conjunction with a "water's edge" unitary approach in taxing the income of Tambrands, including the dividends from the foreign affiliates. Tambrands argued that the property, payroll and sales of the foreign affiliates should have been taken into account in the

apportionment formula.

The Court looked at the *Container*, supra, internal and external consistency tests and concluded that the external consistency test was not violated. The distortion of income was 14.9% which, according to the Court's footnote citing *Container*, is "within the substantial margin of error inherent in any method attributing income among the components of a unitary business." The Court, therefore, found that the tax did not violate the external consistency test.

The Court found that the internal consistency test, however, was violated because the dividend income was being taxed by the foreign country, as well as the United States. In the instant case, there is no violation.

The proper application of the test is to apply the test as though every jurisdiction, foreign and domestic, used South Carolina's apportionment formula. If all jurisdictions used the identical three-factor formula South Carolina uses, only 100% of NCR's income is taxed. This is true since each jurisdiction would receive a portion of the income based only on the percentage of the payroll, property and sales in their taxing jurisdictions. Accordingly, no more than 100% of the income could ever be taxed.

Here, the royalty and interest income are not taxed twice. South Carolina gives a deduction for the payment of the royalty and the interest, and such income is taxed only once. That tax is upon the receipt by NCR. Thus, there is no violation of internal consistency.

There is no violation in the instant case.

3. *Homart Development Co. v. John H. Norber, Tax Administrator*, 529 A.2d 115 (1987), Is Of No

Assistance To NCR Since *Homart* Is A Partnership Case In Which A Flow Through Approach Was Used And Is Not Relevant To A Corporate Taxpayer.

Homart Development Company was a Delaware Corporation with its commercial domicile in Illinois. Homart was engaged in the development of shopping centers both inside and outside of Rhode Island. Homart was also the general partner in several partnerships which were also engaged in real estate development. Homart's general partnership activities were conducted outside the State of Rhode Island. Rhode Island contended that the income from Homart's general partnerships should be included in the overall corporate income of Homart; however, the payroll, property and sales of the partnership interests should not be included in Homart's apportionment formulas.

Rhode Island contended that this treatment was proper under the separate entity theory. Since the partnerships were separate entities, the partnership factors should not be used in determining corporate apportionment. The Court found that Rhode Island's apportionment method did not fairly reflect the business which was carried on in the State of Rhode Island and required that the property, payroll and sales of the partnerships be considered in apportioning the income.

This decision is correct and is consistent with South Carolina law. For South Carolina tax purposes, property, payroll and sales of partnerships pass through to the partner to be considered in the partner's apportionment formula.

The vital distinction between Homart and NCR is that the partnership is a pass through entity; therefore, all income of the partnership is passed through and the recipient is taxed while the partnership itself is not taxed. In the case of NCR,

South Carolina does not tax any of the net income of the subsidiaries. Thus, consistent with *Homart*, South Carolina would not include any of the payroll, property and sales of the subsidiaries.

D. An Argument That A Formula Creates An Inevitable Overtaxation Of NCR Carries No Constitutional Importance Where The Formula Is The Well Accepted Three-Factor Formula.

NCR argues that the formula used in South Carolina inevitably results in overtaxation. NCR is incorrect for obvious reasons.

NCR asserts it will always be overtaxed every year unless South Carolina gives greater weight to representing the royalty and interest income in the denominator of the formula. All that is required of the State is that the formula "reasonably represent the activities carried on in the State." *Moorman*, supra.

South Carolina in its formula has allowed factor consideration for the royalty and interest by an adjustment that increases the sales denominator by including the royalties and interest. Such a practice is a sufficient factor representation and is one employed in close to thirty states. To vary from the standard practice and to grant greater weight in the formula must be established by application of the "gross disparity" test of Due Process.

NCR asserts the alleged overtaxation is due to the structure of the formula itself. It assumes that showing the formula is flawed is the same as showing the formula is inherently unconstitutional. Nothing could be further from the truth.

The three-factor formula has been conclusively found to be

fair and is the benchmark against which other apportionment formulas are judged. *Container*, supra, at p. 2943. Yet even the "benchmark" is inherently flawed and has been specifically identified as being imperfect for at least three reasons.

> First, the one-third-each weight given to the three-factors is essentially arbitrary. Second, payroll, property, and sales still do not exhaust the entire set of factors arguably relevant to the production of income. Finally, the relationship between each of the factors and income is by no means exact.

Container, supra, at p. 2950, ftn. 20.

Despite these serious problems, the Court has found such a formula to be fair. Thus, whether South Carolina's use of the three-factor formula "always overtaxes" is not the relevant question since the three-factor formula always has inequities. *Container*, supra. Even if the formula did overtax, the test is still whether the taxpayer can show a gross disparity. NCR has shown no gross disparity, and thus, the Petition should be denied.

CONCLUSION

The Petition for Certiorari should be denied.

Respectfully submitted,

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